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IN THE

Supreme Court of the United States

OCTOBER TERM, 1937.

No. 723.

GUY T. HELVERING, Commissioner of Internal Revenue,
Petitioner,

vs.

NATIONAL GROCERY COMPANY,
Respondent.

On Petition for a Writ of Certiorari to the United States Circuit Court of Appeals for the Third Circuit.

BRIEF FOR THE RESPONDENT IN OPPOSITION.

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Opinions Below.

The opinion of the Board of Tax Appeals together with the dissenting opinion (R. 17-32) is reported in 35 B. T. A. 163.

The opinion of the Circuit Court of Appeals (R. 172-180) is reported in 92 Fed. (2d) 931.

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered on October 21, 1937 (R. 180).

Petition for certiorari was filed on January 20, 1938.

The jurisdiction of the Court is invoked under section 240(a) of the Judicial Code as amended by the Act of February 13, 1925.

The Question Presented.

The Circuit Court of Appeals, having found that there was no evidence substantial or otherwise to sustain the determination of the Board of Tax Appeals that respondent was availed of during the taxable year for the purpose of preventing the imposition of the surtax upon its sole stockholder, did it err in reversing said determination?

Statute and Regulations Involved.

The statute and regulations involved are set forth in the Appendix, *infra*, pp. 29-33.

Statement.

This case involves the legality of an attempted assessment under Section 104, Revenue Act of 1928, of a penalty tax of $477,360.68 for respondent's fiscal year ended January 31, 1931 (R. 11-14). For that year respondent had paid normal income taxes of $103,616.60, on net income of $863,471.67 (R. 12) reported on its tax return.

Respondent is in the chain grocery business, its principal office being in Jersey City, N. J.

There was no conflict in the evidence before the Board of Tax Appeals. The only witnesses who testified before the Board were called by respondent. In addition to the testimony of witnesses the Board received in evidence a

number of statements taken from respondent's books showing all the details of respondent's business from the date of its incorporation in 1908 to the time of trial, including the number of stores operated each year, gross sales, salary paid Henry Kohl, the sole owner, State and Federal taxes, wages and rents paid, and in short all the important details of the business. The only evidence introduced on behalf of the Commissioner were certain income tax returns of respondent and Henry Kohl, and a statement showing the surplus of the business from its inception. The proofs showed, without contradiction, that the business had grown from insignificant proportions in 1908 to $25,000,000.00 for the year in question. The details will be referred to later.

This is the first case which has come before the Board or the Courts where the Commissioner attempted to apply Section 104 to a mercantile or industrial activity organized prior to the income tax law, which has consistently followed the policy of ploughing its earnings back into the business (R. 31).

In the year under review, although the taxpayer's income tax return showed large earnings, it in fact suffered depreciation in all of its assets far in excess of the earnings reported. Respondent proved that panicky business conditions prevailed in 1930, and that its purpose in not paying dividends was not to avoid the imposition of surtaxes, but to conserve all its resources for business needs. It further proved that it was at the time negotiating the purchase of another large chain of grocery stores, which purchase would have required all its resources. It further proved affirmatively that its capital and surplus were not in excess of the reasonable needs of the business.

(a) Origin of Business.

Henry Kohl, a foreigner, came to America in 1887, when sixteen years of age, without money or property. He worked as a clerk in grocery stores and saved a few hundred dollars (R. 63).

In 1891, having saved $217.00, he and a friend, as partners, bought a grocery store for $500.00. A short time later they bought a second store for $250.00, paying half cash. The partnership dissolved, each partner taking one store.

By 1900, Kohl had purchased two stores.

In 1906, he had three stores and that year incorporated them into Henry Kohl Company, a New Jersey corporation. These were old-time grocery stores doing business on credit.

In 1908, his stores losing money, Kohl conceived the idea of selling groceries on the cash and carry basis in individual packages and organized respondent, National Grocery Company, which opened one store.

After about six months, this store proved very successful and respondent opened additional stores as fast as its limited capital would permit (R. 63, 64).

In 1911, Kohl merged Henry Kohl Company into the National Grocery Company and increased its capital to $200,000.00.

Henry Kohl always owned all the stock of the corporation.

(b) Growth of Business on Its Earnings.

From its organization in 1908 until the year under review (January 31, 1931), respondent pursued the policy of retaining all possible earnings in the business and of constantly expanding on its own earnings. This was the policy

of thrift that Kohl himself had pursued from the day he landed at Castle Garden, a penniless emigrant.

The Company has never been financed or expanded on borrowed money and never sold any stocks or bonds to the public (R. 77). Mr. Kohl never put anything into the business by way of securities or contributions to capital (R. 83).

The capital and surplus of the Company under Kohl's method grew from $20,943.46 in 1908, to $8,138,965.54 as of January 31, 1931 (Ex. 6, R. 136). During this same period, the number of stores grew from three in 1908 to eight hundred and fifteen in 1930. The number of employees grew from a handful in 1908 to twenty-three hundred and thirty-two in 1930. In 1930 the wages paid employees aggregated $3,132,891.99 (Ex. 9, R. 140). The purchases in 1930 aggregated $19,993,937.83, and rents paid aggregated $929,918.70 (Ex. 10, R. 141). In 1930, by discounting its bills, the Company saved $493,719.24 (Ex. 10, R. 141). The Company's gross sales grew from $181,028.11 in 1908, to $25,142,537.41 in 1930 (Ex. 7, R. 138). In 1930, the Company owned and operated a large bakery (Ex. 17, R. 150), an office building, warehouses, and garage (Exs. 16 and 18, R. 148 and 152). These were built to serve between 1,500 and 2,000 stores (R. 78). In every year from 1908 to 1932 the number of stores increased (Ex. 4, R. 132). Sales increased every year up to 1930 excepting in 1921 and 1922 (R. 138).

From the first year the Company was in business it invested surplus money in stocks, and purchased its first bonds in 1917. Its stockholdings increased from $750.00 in 1907 to $2,676,061.47 in 1930 (cost figures), and that date its bonds cost $313,391.27 (Ex. 6, R. 136).

A list of the securities owned with their cost and market at the beginning and end of the taxable year ended January 31, 1931, appears as Exhibit 15 (R. 146).

Mr. Kohl testified that the surplus funds of the Company were invested in securities "so that when we would need it we would have it. All corporations do that more or less. * * * It was part of our business. We carried that money, of course, principally to have the money on hand and get something for it. * * * You know, you can turn that stuff over in the morning, in a couple of hours, and you have your money if you want it" (R. 75, 76). Corroborated by Miss Mullins (R. 77).

From the incorporation of the Company in 1908 to January 31, 1931, Henry Kohl's salary had aggregated $1,026,570.00, while in the period from 1912 to January 31, 1931, respondent had paid Federal income and excess profits taxes aggregating $1,842,719.79 (Ex. 4, R. 132).

(c) No Gains Accumulated in the Taxable Year.

Respondent actually had no gains or profits in the year under review.

The income tax return filed by respondent for the fiscal year ended January 31, 1931, showed

Net income taxable under Section 13 of the Revenue Act of 1928	$863,471.67
Non-taxable income	90,858.40
Net income	$954,330.07

(See Commission's letter R-11 and Statement R-12, 13.)

The Company paid normal income taxes aggregating $103,616.00 (R. 14).

Exhibit 15 (R. 146) shows that respondent suffered depreciation in securities for its fiscal year ended January 31, 1931, aggregating $943,517.42.

Mr. Ferguson (R. 93), Mr. Field (R. 87), and Mr. Armbruster (R. 96) testified that the local bank stocks should be eliminated from the statement because they were unsalable, had no liquidity, and could not be used as collateral for loans. In other words, the Corporation could not raise money by selling them; and they had lost all their value for obtaining credit or borrowing money.

Therefore the following securities must be eliminated from Exhibit 15 (R. 146) to see the true condition of respondent:

Commercial Trust Company of New Jersey	$ 768,240.00
First National Bank of Jersey City	38,600.00
Hudson County National Bank	127,654.00
First National Bank of Hoboken	15,360.00
New Jersey Title Guarantee & Trust Company	60,288.00
Trust Company of New Jersey	58,480.00
Total	$1,068,622.00
Deducting from the market value of all securities 1/31/31	$2,125,434.50
the estimated value of the local bank stocks, as shown above	1,068,622.00
there remains a market value of all the securities in the portfolio of	$1,056,812.50

The evidence thus establishes that National Grocery Company between January 31, 1930, and January 31, 1931, suffered depreciation as follows:

Securities (R. 146)	$ 943,517.42
Inventory*	376,457.56
Real Estate**	125,000.00
Total	$1,444,974.98
If we add to that figure the quoted market value of the local bank stocks, to wit	1,068,622.00
the gross depreciation suffered in the fiscal year ended 1/31/31, was	$2,513,596.98
Deducting from this figure total net income (p. 6, *supra*)	954,330.07
we find that in the year 1930 the Company's net worth shrank in value	$1,559,266.91

What more graphically could show the necessity of an adequate surplus than such shrinkages!

Therefore the Company had in fact no accumulation of gains and profits within the meaning of Section 104 in its fiscal year ended January 31, 1931.

The Company did not sell any of the above securities to make a deductible loss under the Revenue Act, although it could readily have done so, and wiped out all the net income and saved the normal income tax of $103,616.60 which it paid. Such realized losses would also have obviated all questions under Section 104.

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* From Ex. 6, R. 136—Mullins estimated the inventory loss when testifying at $200,000.00–$250,000.00 (R. 81).

** R. 98.

(d) The Evidence as to Respondent's Purpose.

The testimony is without dispute that the intention of the taxpayer from its organization up to the date of trial was to expand; to build up a "chain" of stores; to continually increase the number of stores in its chain.

An examination of the evidence discloses that this purpose existed from the formation of the National Grocery Company, and that from that beginning (at a time when there was no income tax, or undistributed profits tax) the taxpayer consistently adhered to the policy of accumulating gains and profits for the purpose of building up the business. This was Kohl's policy while he lived in the back of a store, cooked his own meals, and as he stated it, lived "as all poor devils do" (R. 63).

Mr. Kohl, respondent's President, testified the purpose of National Grocery Company was to open more and more stores; that they wanted more stores.

After relating his early struggles he said, speaking of the merger of the Henry Kohl Company with National Grocery Company in 1911:

> "After this merger I had fifty-seven stores. It is quite a question how I financed the additional stores. I did it by using all of the money I could borrow and what little I made in profits" (R. 65).
>
> * * * * * * *
>
> "As time went on and by the method of keeping all of my profits in the business, except what were necessary for my bare living expenses, 'I was independent and did not want to sell it' " (stock in his company).
>
> * * * * * * *

"I expanded the business year by year * * * and financed the expansions with the profits I made from year to year, leaving them right in the business" (R. 66).

* * * * * *

"The National Grocery Company had in mind opening more and more stores. I always had great big ideas" (R. 67).

"Our system was right and the public wanted them, but we could not carry it out all the time. Competition came, but we wanted plenty of stores. We had to have a certain amount of capital in order to have credit. Your credit depends on your statement. 'If you don't have a decent statement you cannot buy your merchandise right or do anything right.' The National Grocery Company had to buy large quantities of merchandise all the time. Ever since we have been able to discount our bills we have been doing it. It is a very important thing in our business to get the discounts and pay cash for merchandise. That is the inner profit of the business.

"For the year 1930 the discounts amounted to $434,000. The purchases for that year were in excess of $19,000,000, and the discounts were almost two per cent of that figure. In order to make those purchases and take our discounts we had to have large capital" (R. 67, 68).

Again, Mr. Kohl testified that he had been on the lookout at all times to buy an existing chain of stores. He said that in 1929 and 1930 Mr. Bohack of the H. C. Bohack Company, in Brooklyn, was alive, and offered to sell his chain of five or six hundred stores, and he seriously considered purchasing part, if not the whole of the business. He made a careful survey of the business to see if it was profitable to purchase, but while the negotiations were pending Mr.

Bohack became ill and died. The negotiations were resumed as late as last year (1936). The Bohack Company is a large concern, five or six million dollars (R. 70).

Mr. Kohl also testified that he kept all the earnings in the business, because "I needed them in the business—always needed them in the business. I never had any too much money in my business." (R. 72).

In this connection Mr. Kohl said:

> "* * * Even with all the capital that the Company had we had to borrow money from the banks occasionally as it was needed. We needed it to buy butter and eggs and put them in storage, and to buy merchandise when it was the right time to buy. Frequently you need more money that you have got. It takes all of the money we have got to swing that. We buy butter every day, but in June we buy butter for the next Winter.
>
> Q. How about coffee—do you buy that in large quantities? A. That all depends.
>
> Q. On what? A. If war were declared tomorrow we would buy a year's supply and would be fortunate to have the money to do it with" (R. 72).

Again:

> "It has been the habit with us to keep in the business every possible dollar, and let that accumulate for the benefit of the business. I think it is good business judgment and I guess everybody else does. The bankers tell you that. If we had adopted a different policy and in the good years from 1920 to 1930 had drawn out of the business a large part of our profits, I do not think we would have been able to withstand the effect of this depression the way we have. I think those concerns who did do that have gone" (R. 73).

He testified that:

> "I did not refrain from paying dividends in the National Grocery Company in 1930 in order to avoid the payment of any government taxes. I have never done that" (R. 75).

Miss Mullins, Treasurer of the Company, who had been associated in the business with Mr. Kohl since 1897, when he had one store, fully corroborated Mr. Kohl's testimony (R. 77). She said:

> "It has been Mr. Kohl's policy from the formation of the business that he could make more money by reinvesting the earnings in the business than in any other type of investment" (R. 77).
>
> * * * * * *
>
> "When Mr. Kohl had one store he promised me he would have ten some day. After he had ten and he thought if I would stay a little longer maybe he would have a hundred, and that has been his policy right along" (R. 78).
>
> * * * * * *
>
> "I believe in 1919 we had two hundred stores. At that time Mr. Kohl was figuring on having a thousand. When he got up to six and eight hundred stores his plan was to have two thousand" (R. 78).

She testified that the present warehouse and bakery and machinery are built to take care of between 1,500 and 2,000 stores (R. 78). This fact shows that the purpose of the management was to increase the number of stores as opportunity offered to double the 815 operated in 1930.

She also said:

> "It is my opinion, as Treasurer of the Company, that in the year 1930 the surplus was not in excess of the reasonable needs of the business, and is not today, although conditions are different. In order to finance the purchase of $20,000,000 worth of merchandise and pay a million dollars in rents per annum, the Company required its surplus, in my opinion. There were times even at that when we were short of cash, and had to borrow temporarily from the banks in order to pay for incoming merchandise" (R. 79).

Miss Mullins corroborated Mr. Kohl's testimony about negotiations with Mr. Bohack in 1930 for the purchase of his business, and also negotiations for the purchase of a chain of stores in Paterson, New Jersey (R. 79, 80).

Mr. Field testified that a company like respondent to get the full advantage of a chain store business must cover with stores the total territory that can be reached with trucks from its central warehouses (R. 87, 88).

At Mr. Kohl's request Mr. Field tried to induce the owners of one chain of stores to sell to respondent (R. 89).

The management of respondent saw values of everything steadily declining in the year under review. They were negotiating a great expansion through the acquisition of the H. C. Bohack chain of stores in Brooklyn and Long Island.

> "Any conservative management would have conserved all its ready cash, because they did not know what the future would bring forth" (Field, R. 91; Ferguson, R. 92, 93).

The Board's Decision.

The Board of Tax Appeals divided eight to seven. The findings of fact and opinion of the majority confirming the assessment by the Commissioner completely ignored the evidence proving respondent's need of large capital in these particulars:—(a) of the number of employees and wages paid; (b) rents paid; (c) amount of purchases; (d) the testimony of Mr. Kohl, Miss Mullins, Mr. Field and Mr. Ferguson that the capital and surplus was not in excess of the reasonable needs of the business; (e) the testimony of Mr. Kohl and Miss Mullins relative to plans for expansion and purchases; (f) the testimony of Mr. Kohl and Miss Mullins that the Company did not have any intention of evading taxes in not paying dividends; (g) that for the year in question the Company in fact suffered a net loss when the market value of its assets was considered, although an examination of the income tax return on the Government blank showed net profits on its face.*

The majority opinion and findings of fact stressed the earnings of the Company, its investment in securities, its failure to pay dividends, loans to Mr. Kohl in 1930 of $140,000 and prior loans, and concluded that petitioner was availed of for the prohibited purpose (R. 18-24).

The majority of the Board proceeded on the erroneous assumption that the presumption created by Section 104(b) of the statute cast the burden on the taxpayer of proving that it was not availed of for the prohibited purpose, and

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* The income tax law does not take into consideration depreciation in the portfolio of securities and real estate, but only gains and losses determined by sales. In this taxpayer's method of accounting, the inventory was carried at cost or market, whichever was lower, and this method was followed in the year under review.

did not have gains and profits in excess of the reasonable needs of the business.

The opinion of the Board says:

> "Does the evidence overcome this *prima facie* presumption" (R. 22)?

The Board concluded:

> "We are also of the opinion that the evidence of record does not rebut the *prima facie* presumption created by the statute" etc. (R. 23).

The Commissioner had offered no proof before the Board as to what the reasonable capital needs of respondent are. No one will contend that it needs no capital. Without adequate capital it could not have discounted its bills payable, and such discounts in the year under review amounted to $493,719.00 (Ex. 10, R. 141), or fifty-seven per cent of the net earnings for the year.

The respondent had affirmatively proved by its President and Miss Mullins that it needed all of its capital in its business.

The Board of Tax Appeals made its finding from an examination of the balance sheet alone, wholly disregarding the testimony of Mr. Kohl, Miss Mullins, Mr. Field, and Mr. Ferguson, that respondent's capital and surplus were not in excess of the reasonable needs of the business.

Likewise, the Board's conclusion that respondent's purpose in not paying a dividend in 1930 was to avoid the imposition of the surtax on Mr. Kohl, was supported by no evidence. There was nothing whatsoever to support it except the statutory presumption, and respondent having gone forward with its proofs and having affirmatively shown that

it had no such purpose (*United Business Corporation* vs. *Commissioner*, 62 Fed. (2d), 754; certiorari denied, 290 U. S., 635), the presumption automatically fell out of the case.

> *Pariso* vs. *Towse*, 45 Fed. (2d), 962 (*infra*, p. 21).

The minority of seven, speaking through Member Mellott, took into consideration the testimony above referred to that had been ignored by the majority of the Board, and concluded:

> "The inquiry as to whether there has been an accumulation of surplus beyond the reasonable needs of the business is not determinative of the ultimate question to be decided. Even if the evidence be sufficient to show that there was an unreasonable accumulation—which, however, I do not believe has been shown in this case—this merely raises a rebuttable presumption of the existence of the crucial purpose. Such presumption is overcome by the evidence in this case which shows an absence of such purpose. The corporation merely continued its long established practice of 'ploughing its earnings back into the business.' Indubitably it had in the earlier years no 'purpose of preventing the imposition of the surtax upon its shareholders', for there was no surtax to escape. There had been no 'sudden change of policy, coincident with large increases in the surtax rates, (which) might * * * betray a purpose to accumulate against a season more propitious for distribution.' (*United Business Corporation*, 62 Fed. (2d) 754). It had pursued the same policy throughout the years" (R. 30, 31).

The Decision of the Circuit Court of Appeals.

In due time the respondent appealed to the United States Circuit Court of Appeals for the Third Circuit, and assigned seventeen assignments of error (R. 39-44).

The Circuit Court of Appeals, in an opinion by Judge Buffington, carefully reviewed all the evidence that was before the Board, and said:

> "We limit ourselves to holding that the Tax Board had before it no proof, substantial or otherwise, to support its imposition of this penalty tax. Its judgment is therefore reversed" (R. 172, 178).

ARGUMENT.

I.

No new question of law is involved.

Petitioner contends that the Circuit Court of Appeals so far departed from the accepted and usual course of judicial procedure as to call for the exercise of this Court's power of supervision.

Two months ago, petitioner filed a brief in this Court opposing the granting of a writ of certiorari in *Almours Securities, Inc.* vs. *Guy T. Helvering, Commissioner of Internal Revenue (No. 613 October Term)*, in which petitioner said (p. 13):

> "Examination of *National Grocery Co.* v. *Helvering, supra,* discloses no conflict with the decision below. The Circuit Court of Appeals for the Third Circuit merely held 'that the Tax Board had before it no proof, substantial or otherwise, to support' it.

"Both that court and the court below treated the question before them as one of fact and directed their inquiry to the question whether or not the ultimate finding of the Board had any substantial support in the evidence in the case. Because of the supposed nature of the evidence in the *National Grocery* case, the court held that the ultimate finding had no support in the evidence. Both courts applied the same legal principles of judicial review. The cases diverged because of differences in the analyses of fact situations and the state of the records presented in the two cases.

"The comparative analysis drawn by the petitioner (Br. 30) between the cases ignores the very consideration given predominant weight in the *National Grocery* case. The petitioner here was a mere holding or investment corporation (see *infra*, pp. 14-18), which fact alone raises a statutory presumption of the interdicted purpose, while the National Grocery Company was an actively operating company. The court there concerned itself with showing that the Government had not submitted proof rebutting the taxpayer's evidence to the effect that the sums withheld were reasonably necessary for a rapidly expanding grocery store business, a consideration which in itself is obviously sufficient to avoid any conflict with any ruling of law in the instant case."

In a footnote at the bottom of page 12 of said brief, the Government said:

"A dictum in the *National Grocery* case indicates that the court viewed the decision as to the purpose for which the corporation was formed or availed of as a question of mixed law and fact. This statement did not enter into the decision of the case."

Certiorari in the *Almours Securities Company* case was denied January 10, 1938.

II.

The evidence before the board was not disputed.

In its second reason for the issuance of a writ petitioner contends that the Circuit Court of Appeals substituted its judgment for that of the administrative body.

What the Board of Tax Appeals actually did, was wholly to disregard a large portion of respondent's evidence, particularly the evidence as to what motivated respondent's business conduct, the purpose for which it accumulated its earnings, its need of large capital for operating and expansion purposes and the sworn testimony that its surplus was not in excess of the reasonable needs of its business and was not accumulated to avoid any taxes.

No witness for the Commissioner testified that the ratio between capital and surplus and business done was too large. No witness contradicted the taxpayer's evidence in any respect.

The Board of Tax Appeals merely picked out of the taxpayer's balance sheet certain items, compared the ratio between the capital and the surplus, noted that the corporation had a surplus of $7,938,965.54 (R. 23) (which figure disregarded all depreciation of every kind), and that it had loaned a comparatively insignificant amount to its principal stockholder, and from those facts alone concluded that since its income tax return for 1930 showed large net earnings which it did not distribute in dividends, it therefore had the purpose to evade the imposition of the surtax.

The Board entirely ignored the most important factor, *i. e.*, the ratio between the capital and surplus, on the one hand, and business done, on the other. Respondent's annual turnover was 6 to 8 times its working capital (R. 86).

The Board entirely disregarded the proven fact that this corporation, which operated a chain of grocery stores throughout Northern New Jersey, Staten Island, and a part of New York, also owned and operated a large central distributing plant, a large administrative building, a large bakery, garages, storage warehouses, a fleet of automobile trucks, and at all times carried large stocks of merchandise in its stores and warehouses to serve over 100,000 customers daily (R. 83). Capital was the life-blood of this business.

The Board ignored the fact that the taxpayer had 2,332 employees, who had to be paid regularly wages aggregating $3,132,891.99 per annum, and that it had annual rents to pay aggregating $929,918.70, as well as State, City and Federal taxes, to say nothing of bills for merchandise aggregating $19,998,937.83 in the year under review.

The Board ignored the fact that sound business principles require the accumulation of surplus in times of plenty against the coming of times of famine, the likelihood of wars, recession, depression, strikes, drought, floods and the consequent scarcity of merchandise.

Respondent, as we have heretofore shown, proved affirmatively and convincingly that its capital and surplus were not in excess of the reasonable needs of the business, and that it did not fail to pay dividends in the year under review to avoid the imposition of surtaxes on its sole stockholder. The Government introduced no evidence; and as a matter of law the presumption contained in Section 104(b)

disappeared when the taxpayer went forward with sworn testimony and overcame the presumption.

See *Pariso* vs. *Towse,* 45 Fed. (2d), 962, where Judge Hand said:

> "In *Potts* vs. *Pardee, supra,* page 433 of 220 N. Y., 116 N. E., 78, and *Rose* vs. *Balfe,* 223 N. Y., 481, 486, 487, 119 N. E. 842, it was said that the presumption disappears upon any 'substantial' evidence in defense; and this would appear to imply no more than that the defendant in the prescribed situation must proceed or lose." . . . "Thus it follows that the office of a presumption must disappear when the opposite side puts in proof, and the party charged with the burden of proof must fail, if he goes no further, or cannot use his adversary's evidence as support of the affirmative. To hold otherwise would be to impose the burden of proof upon the party having the negative."
>
> *Western & A. R. Co.* vs. *Henderson,* 279 U. S. 639.

In the face of the convincing testimony that respondent corporation did not have more capital than its business required, and occasionally was obliged to borrow for short periods to pay for incoming merchandise (R. 79), what was there to support the Board's finding that respondent's profits were in excess of the reasonable needs of the business?

Every business must have capital. Even the newsboy must have a few pennies with which to purchase the papers he sells on the street corner. No corporation can grow and have a healthy business that distributes all its earnings. The capital required to run one business would be wholly inadequate for another business. The National Grocery

Company with 2,300 employees and 800 stores requires far more capital than the grocer with one store and three employees.

There was not a particle of evidence before the Board to warrant it in making the conclusion it did.

We submit that the Circuit Court of Appeals could properly have made no other finding in the face of the undisputed testimony contained in this record.

III.

The purpose to evade surtaxes is not proved by mere showing that a corporation is able to pay dividends.

The petition for certiorari charges that the Court below overlooked facts indicating that a sizeable portion of respondent's profits for the taxable year could have been declared as a dividend, without curbing in the slightest the reasonable needs of the business (p. 15), contending (1) that the accumulations were not needed to acquire new stores; (2) they were not needed in the business, and (3) they were not needed because of the depreciation taxpayer suffered.

This argument entirely disregards the fact found by the Board, that:

> "For many years the petitioner has contemplated greatly expanding the number of stores operated. For a time it negotiated for the purchase of stores in Paterson, New Jersey, and also for stores in New York City proper, and for a large chain of stores in Brooklyn, New York. The petitioner has not, however, made the contemplated expansions because in

> the opinion of the petitioner's president, Henry Kohl, the stores could not be purchased at what he regarded as a fair price'' (R. 18, 19).

The evidence shows that these negotiations were carried on in 1929 and 1930 (Kohl, R. 70; Mullins, R. 79, 80).

Mr. Kohl testified that the H. C. Bohack Company, which he was negotiating for, was a large business, running into five or six million dollars (R. 70).

If this purchase had been made respondent would have needed every dollar of its surplus.

This case cannot be considered or decided on the same basis as that of a corporation formed by a rich man, who transfers to it his cash and securities in exchange for stock, and uses the corporation as a means of tax avoidance. Such a corporation needs very little money, and it may be that Section 104 requires such a corporation to distribute a large part of its net earnings.

To enforce the same rule on corporations like respondent, which are engaged in an active mercantile and manufacturing business, would result in the stifling of business. What business can continue to grow and expand if it is to be subjected to the normal income taxes and the fifty per cent penalty tax of Section 104?

It is to be noted that Section 104 does not specify how it can be avoided by the payment of dividends; what dividends should be paid; what surplus a business may properly have.

An attempt was made to assess a penalty tax of fifty per cent under Section 220 of the former law (now Section 104) on National Grocery Company for its fiscal years ended January 31, 1923, and January 31, 1924. The tax was

set aside on appeal to the General Counsel of the Bureau of Internal Revenue (Ex. 1, R. 105).

Again an attempt was made to assess the penalty under Section 220 on respondent for the fiscal year ended January 31, 1928. Respondent protested and after hearing the protest was sustained (Ex. 1, R. 125).

The record below shows a tremendous growth in this business after these attempts were made. For the year ending January 1925, the Company had 1,462 employees, paid them wages of $1,683,947.70 (Ex. 9, R. 140), and operated 482 stores with gross sales of nearly $16,000,000.00 (Ex. 7, R. 138). For the fiscal year ended January 31, 1929, the Company had 2,210 employees, paid them wages of $2,825,615.53 (Ex. 9, R. 140), and operated 782 stores, with gross sales of $24,116,343.72 (Ex. 7, R. 138). Two years later (the fiscal year under review) the number of employees had increased by 122, wages had increased by $307,000.00 per annum, stores had increased from 782 to 815, and gross sales had increased by over $1,000,000.00.

Is it probable that any such increase would have followed the collection of the fifty per cent penalty in 1924, 1925 or 1928?

The test under Section 104 is not whether a corporation is able to pay dividends but rather, is it used as an instrument of tax avoidance. The question raised by the statute is whether gains and profits are permitted to accumulate for the *purpose* of avoiding surtaxes that otherwise would fall on the owner. This statute does not impose a tax on corporations because they do not pay dividends when they might do so—as petitioner seems to contend. That is the theory of later legislation imposing a surtax on undistributed profits of corporations generally (Rev. Act 1936, Sec. 14; 49 Stat., 1655).

No intention of the management of this business to avoid taxes can be found in this record. To the contrary, from the beginning of this corporation in 1908 to the year under review there has been a steady growth year by year through the policy of ploughing all possible earnings back into the business. The net result is that the Government has received in taxes more than the owner; employees received more in wages for the year under review than the owner received during the entire history of the business, and those engaged in trade and commerce have sold the Company many millions of dollars of merchandise.

Loans to Kohl Did Not Prove the Forbidden Purpose.

In the year under review Mr. Kohl temporarily borrowed from his Company $140,000.00. He had developed a heart condition and used $40,000.00 to purchase a residence in Florida. He borrowed $100,000.00 in order to make a contribution to complete a home for the Young Women's Christian Association in Jersey City (R. 70). He gave the Company demand notes for the amounts (R. 71). The amounts loaned were entered on the books under the head of "Notes receivable" and appeared in every statement the Company made (R. 81). The reason he borrowed from the Company instead of declaring a dividend was that he expected to repay and the surplus account would not be lowered, whereas if he had declared a dividend the money would be permanently out of the business (R. 79).

Mr. Field, President of the Commercial Trust Company of New Jersey, testified that:

> "I don't think it would have made much difference whether he borrowed the money from the bank or his own company" (R. 89).

On cross examination he said:

> "I presume that Mr. Kohl's borrowings from the corporation was a good asset for the corporation" (R. 92).

On re-direct:

> "We have considered the item of $610,000 owed by Mr. Kohl to National Grocery Company an asset of the Company, collectible whenever the Company elected to collect it" (R. 92).

In effect the Commissioner conceded these loans are good and collectible for he includes the notes receivable in the surplus (Exs. 5 and 6, R. 134, 136).

The element of loans by a corporation to a stockholder is not in any sense a fair test of a purpose to evade taxes.

Suppose a corporation is in the banking business, all of its stock being owned by one man. The business of a bank is to loan money. If the bank loaned money to its sole stockholder against his note, could it be said that because he borrowed from the bank which he owned, that thereby an intention was shown to use the corporation to evade taxes?

The facts conclusively show that Kohl borrowed from his corporation temporarily. He so handled the matter that for the purposes of credit the surplus was not depleted. The fact is that within seven weeks of the end of the year, he repaid $60,000.00 of his temporary borrowings, during the following year he paid off $65,000.00, and May 4, 1933 he paid off $86,000.00 (R. 142). The Commissioner's notice of the attempt to assess this penalty tax was dated April 25, 1934 (R. 11) and was received about a year after all the

loans in the year under review, and a part of the earlier loans had been repaid. This clearly demonstrates that the purpose of the stockholder was to retain all assets in the corporation, according to its historic policy, for continued growth and expansion.

In *United States* vs. *Tway Coal Sales Co.*, 75 Fed. (2d) 336, the taxpayer sued for the recovery of taxes paid after an assessment under Section 220 of the former law. Judgment for the taxpayer in the District Court was affirmed by the Circuit Court of Appeals (Sixth Circuit), despite the fact that the sole stockholder had borrowed relatively larger sums from his corporation than Kohl did from National Grocery Company.

IV.

Section 104 being a penal statute, must be construed strictly and in the light most favorable to the taxpayer.

Section 104 of the Revenue Act of 1928 imposes a penalty of 50 per cent *of the income,* including dividends and income from tax exempt securities, and all other income, while Section 293(b) of the Revenue Act of 1928 provides that for fraud the penalty is *50% of the tax.*

> "If any part of any deficiency is due to fraud with intent to evade tax, then 50 per centum of the total amount of the deficiency (in addition to such deficiency) shall be so assessed, collected, and paid, in lieu of the 50 per centum addition to the tax provided in Section 3176 of the Revised Statutes, as amended" (Sec. 293 (B), Rev. Act, 1928).

Since Section 104 imposes a penalty far greater than for fraud, it should be construed most strongly against the Government.

Gould vs. *Gould*, 245 U. S. 151;
Crocker vs. *Malley*, 249 U. S. 233;
U. S. vs. *Field*, 255 U. S. 262;
Smietanko vs. *First Trust Bk.*, 257 U. S. 606;
Shwab vs. *Doyle*, 258 U. S. 534;
U. S. vs. *Merriam*, 263 U. S. 188;
Hecht vs. *Malley*, 265 U. S. 156;
Reinecke vs. *Northern T. Co.*, 278 U. S. 348;
Aluminum Castings Co. vs. *Routzahn*, 282 U. S. 100;
Old Colony vs. *Commissioner*, 284 U. S. 561.

Conclusion.

We respectfully submit that the decision of the Circuit Court of Appeals is correct. The Court below finding that there was no evidence to support the action of the Board properly reversed.

Respectfully submitted:

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Appendix.

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 104. ACCUMULATION OF SURPLUS TO EVADE SURTAXES.

(a) If any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there shall be levied, collected, and paid for each taxable year upon the net income of such corporation a tax equal to 50 per centum of the amount thereof, which shall be in addition to the tax imposed by section 13 and shall be computed, collected, and paid upon the same basis and in the same manner and subject to the same provisions of law, including penalties, as that tax.

(b) The fact that any corporation is a mere holding or investment company, or that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be *prima facie* evidence of a purpose to escape the surtax.

(c) As used in this section the term "net income" means the net income as defined in section 21, increased by the sum of the amount of the dividend deduction allowed under section 23 (p) and the amount of the interest on obligations of the United States issued after September 1, 1917, which would be subject to tax in whole or in part in the hands of an individual owner.

(d) The tax imposed by this section shall not apply if all the shareholders of the corporation include (at the time of filing their returns) in their

gross income their entire distributive shares, whether distributed or not, of the net income of the corporation for such year. Any amount so included in the gross income of a shareholder shall be treated as a dividend received. Any subsequent distribution made by the corporation out of the earnings or profits for such taxable year shall, if distributed to any shareholder who has so included in his gross income his distributive share, be exempt from tax in the amount of the share so included.

Subdivisions (a) and (b) of Section 220 of the Revenue Act of 1924, c. 234, 43 Stat. 253, and subdivisions (a) and (b) of Section 220 of the Revenue Act of 1926, c. 27, 44 Stat. 9, are substantially identical with subdivisions (a) and (b) of Section 104 of the Revenue Act of 1928.

Treasury Regulations 74, promulgated under the Revenue Act of 1928:

ART. 541. *Taxation of corporation utilized for evasion of surtax.*—Section 104 is designed to discourage the formation or use of a corporation for the purpose of preventing the imposition of surtaxes upon its shareholders, through the device of permitting its gains and profits to accumulate instead of being distributed. If a domestic or foreign corporation is so formed or availed of, it is subject to a tax at the rate of 50 per cent upon its net income in addition to the tax imposed by section 13. However, the additional tax at the rate 50 per cent does not apply for 1928 or any subsequent taxable year if all the shareholders of the corporation include (at the time of filing their returns) in their gross income their entire distributive share, whether distributed or not, of the net income of the corporation for such year or years. Any amount so included in the gross income of a shareholder shall be treated as a divi-

dend received, and any subsequent distribution made by the corporation out of the earnings or profits for such taxable years shall, if distributed to any shareholder who has so included in his gross income his distributive share, be exempt from tax in the amount of the share so included.

ART. 542. *Purpose to escape surtax.—Prima facie* evidence of a purpose to escape the surtax exists where a corporation is a mere investment company, where a corporation has practically no business except holding stocks, securities, or other property and collecting the income therefrom or investing therein, or where a corporation other than a mere holding or investment company permits its gains and profits to accumulate beyond the reasonable needs of the business. The statutory presumption that a mere holding or investment company is subject to the additional tax imposed by section 104 may be overcome if the corporation can show, either by reason of the fact that it distributed a large portion of its earnings for the year in question, or that its stock was held not by the members of a family or of a small group but by a large number of persons and in comparatively small blocks, or by other evidence, that it was not availed of for the purpose of preventing the imposition of the surtax upon its shareholders.

The business of a corporation is not merely that which it has previously carried on, but includes in general any line of business which it may legitimately undertake. However, a radical change of business when a considerable surplus has been accumulated may afford evidence of a purpose to escape the surtax. When one corporation owns the stock of another corporation in the same or a related line of business and in effect operates the other corporation, the business of the latter may be considered

in substance the business of the first corporation. Gains and profits of the first corporation put into the second through the purchase of stock or otherwise may therefore, if a subsidiary relationship is established, constitute employment of the income in its own business. To establish that the business of one corporation can be regarded as including the business of another it is ordinarily essential that the first corporation own substantially all of the stock of the second. Investment by a corporation of its income in stock and securities of another corporation is not without anything further to be regarded as employment of the income in its business.

ART. 543. *Unreasonable accumulation of profits.*— An accumulation of gains and profits is unreasonable if it is not required for the purposes of the business, considering all the circumstances of the case. It is not intended, however, to prevent reasonable accumulations of surplus for the needs of the business. No attempt can be made to enumerate all the ways in which gains and profits of a corporation may be accumulated for the reasonable needs of the business. Distributions made by a corporation shortly after the close of its taxable year shall be taken into consideration in determining the reasonableness of the amount of earnings and profits of the corporation retained by it for such year. Undistributed income is properly accumulated if invested in increased inventories or additions to plant reasonably needed by the business. It is properly accumulated if retained for working capital required by the business, or in accordance with contract obligations placed to the credit of a sinking fund for the purpose of retiring bonds issued by the corporation. In the case of a banking institution the business of which is to receive and loan money, using capital, surplus, and deposits

for that purpose, undistributed income actually represented by loans or reasonably retained for future loans is not accumulated beyond the reasonable needs of the business. The nature of the investment of gains and profits is immaterial if they are not in fact needed in the business. It is an unreasonable accumulation of gains and profits by corporations with the purpose of enabling their shareholders to escape surtaxes on such gains and profits which subjects such corporations to the additional tax imposed by section 104. Among other things, the financial condition of the corporation at the close of the taxable year and the manner in which its funds are invested at that date, determine the reasonableness of the accumulations.

For the purpose of section 104 of the term "net income" means the net income of the corporation as defined in section 21 increased by the sum of (1) the amount received as dividends and allowed as a deduction by section 23 (p), plus (2) the amount of interest on obligations of the United States issued after September 1, 1917, which would be subject to tax in whole or in part in the hands of an individual owner. The Commissioner, or any collector upon direction from the Commissioner, may require any corporation to furnish a statement of its accumulated gains and profits, the name and address of, and number of shares held by, each of its shareholders, and the amounts that would be payable to each, if the income of the corporation were distributed. (See section 149 (c).)

Articles 352 and 353 of Treasury Regulations 65 and Articles 352 and 353 of Treasury Regulations 69 are substantially identical with Articles 542 and 543 of Treasury Regulations 74.